INVESTING

February 1, 2017

Asset Allocation Strategy

Alternative policies, real confusion

Martin Lefebvre
CIO and Strategist
(514) 412-8572
martin.lefebvre@bnc.ca

Simon-Carl Dunberry
Senior Analyst
(514) 412-8384
simon-carl.dunberry@bnc.ca

Highlights

- Investors who hoped that President Trump would be more moderate than "Campaign Trump" are slowly realizing that this will not be the case. While the cloud of uncertainty toward the policies of the new Administration is very gradually fading, we are still left wondering about the exact timing of their implementation as well as their potential impact.
- Short term, the Keystone XL announcement is a non-event as we are still two to three years away from any tangible effect. However, once the pipelines are built, the impact on energy prices will be positive for the Canadian economy, as they will offer more flexibility for producers to sell south of the border. The differential between Western Canada Select prices and WTI should contract, and this will improve Canadian producer margins.
- For the first time since the great financial crisis, the unemployment rate has now reached levels where labor costs will contribute to inflation. This is only one factor amongst many that point toward higher inflation this year. While U.S. dollar strength may drag down import prices, crude oil's base effect (up 57% on a 12-month basis) will act as a counterweight.
- It becomes clearer to us that equities seem priced for perfection. The potential for disappointment is high given the current mindset permeating the markets. Even if the VIX showed some signs of life at the end of the month, we can't shake off the feeling that complacency is prevalent. The White House is now an X-factor and uncertainty, even concerning tax policy, remains and increases the potential for extreme movements. Consequently, we suggest an underweight in US equities in favor of cash.

Table 1 **Global Asset Allocation**

Global Classes	–	Weights			+
Cash				▒	■
Fixed Income		■			
Equities		■	▒		
Fixed Income					
Federal		■			
Investment Grade			■		
High Yield (USD)				■	
Non-Traditional FI				■	
World Equities					
S&P/TSX			■		
S&P 500 (USD)			■		
Growth vs. Value			■		
Large vs Small cap.			■		
Defensives vs Cyclicals			■		
MSCI EAFE (USD)		■			
MSCI EM (USD)		■			
Alternative Investments					
Currency Hedge		■			
Commodities			■		
Energy			■		
Base Metals			■		
Gold			■		
Hedge Funds			■		
REITS / Infrastructure		■			

Source: Consulting Investment Committee

Current Allocation ■
Previous Month Allocation ▒

NATIONAL BANK

Market review

Fixed income

- 10-year yields are still 0.13% off the December peaks and flat since the beginning of the year as investors are uncertain whether the "Trump trade" will continue on the path set since the election.
- In Canada, yields have maintained a tight range since the election, as the economy is starting to show some positive momentum in GDP numbers.

Canadian equities

- The S&P/TSX closed the month 0.8% higher after a good start to the month in which the index almost broke September 2014's record. However, uncertainty about trade agreements started dragging prices down.
- Gold miners (+10.7%) were offset by energy (-5.5%) in a rare divergence of performances from commodity producing companies.

U.S. equities

- The S&P 500 and Dow Jones generated new highs (20,000 for the Dow!). However the triumph was short lived as indices quickly reversed in light of Mr. Trump's policies, which are drawing increasing criticism and creating uncertainty.
- The sectors showed similar performances to their northern counterparts as gold miners benefitted from the increase of the precious metal's price while crude oil was practically unchanged for January.

Commodities

- Speculators are still in wait-and-see mode until proof that the OPEC deal curtailing production is working. For now, prices are stuck in a range and not showing any signs of breaking out either way from the $51 – $55 range.
- Gold finally behaved the way we initially expected after the Trump election and his reflation plans. The fact that real-rates somewhat weakened since their December highs certainly helped.

Foreign exchange

- The greenback took a beating from a combination of profit taking, Mr. Trump's complaining about the currency's strength compared to the Yuan, and uncertainty about the U.S. Administration's plans.
- The Canadian dollar benefitted from such weakness as domestic GDP numbers surprised on the upside, and some positive momentum was generated from the Keystone XL pipeline rebirth.

Table 2 Market total returns

Asset classes	January	12 months	2016
Cash (3-month T-bills)	0.0%	0.5%	0.5%
Bonds (FTSE/TMX Ovr. Univ.)	**-0.1%**	**1.1%**	**1.7%**
FTSE/TMX Short term	0.2%	1.0%	1.0%
FTSE/TMX Mid term	0.2%	1.2%	1.6%
FTSE/TMX Long term	-0.8%	1.2%	2.5%
FTSE/TMX Government	-0.3%	0.0%	0.9%
Federal	-0.1%	-1.0%	0.0%
Provinces	-0.5%	1.1%	1.8%
Municipales	-0.3%	1.4%	2.0%
FTSE/TMX Corporate	0.4%	4.1%	3.7%
AA+	0.4%	2.2%	2.0%
A	0.2%	3.8%	3.6%
BBB	0.6%	5.9%	5.1%
BoAML High-Yield (USD)	1.3%	21.0%	17.5%
Preferred shares	4.0%	24.2%	7.0%
Canada (S&P/TSX)	**0.8%**	**23.6%**	**21.1%**
Energy	-5.5%	27.2%	35.5%
Industrials	0.5%	27.4%	22.8%
Financials	2.3%	28.4%	24.1%
Materials	9.3%	57.0%	41.2%
Utilities	1.4%	12.6%	17.7%
Cons. Disc	-0.5%	17.6%	10.7%
Cons. Staples	-1.4%	4.0%	7.5%
Healthcare	-3.4%	-77.1%	-78.4%
IT	0.3%	9.4%	5.2%
Telecom	2.7%	13.7%	14.7%
REITs	-0.1%	10.7%	9.1%
S&P/TSX Small cap	0.5%	45.1%	38.5%
US (S&P500 / USD)	**1.9%**	**20.0%**	**12.0%**
Energy	-3.6%	26.6%	27.4%
Industrials	1.4%	27.9%	18.9%
Financials	0.2%	35.0%	22.8%
Materials	4.6%	36.5%	16.7%
Utilities	1.3%	12.2%	16.3%
Cons. Disc	4.2%	16.5%	6.0%
Cons. Staples	1.6%	6.4%	5.4%
Healthcare	2.2%	7.7%	-2.7%
IT	4.4%	24.9%	13.8%
Telecom	-2.5%	12.8%	23.5%
REITs	-0.1%	8.3%	3.4%
Russell 2000 (USD)	0.3%	31.5%	19.5%
World eq. (MSCI ACWI / USD)	**2.8%**	**18.6%**	**8.5%**
MSCI EAFE (USD)	2.9%	12.6%	1.5%
MSCI EM (USD)	5.5%	25.9%	11.6%
Commodities (CRB index)	**2.2%**	**12.8%**	**12.9%**
WTI oil (US$/barrel)	-1.7%	56.8%	44.4%
Gold (US$/ounce)	4.7%	8.4%	9.0%
Copper (US$/tonne)	8.5%	31.2%	17.4%
Forex (DXY - US Dollar index)	**-2.6%**	**-0.1%**	**3.6%**
USD per EUR	2.5%	-0.1%	-2.9%
CAD per USD	-3.0%	-6.7%	-2.9%

Source: Datastream 1/31/2017

Trump policies: Good for… 2018?

Investors who hoped that President Trump would be more moderate than "Campaign Trump" are slowly realizing that this will not be the case. While the cloud of uncertainty toward the policies of the new Administration is very gradually fading, we are still left wondering about the exact timing of their implementation as well as their potential impact. Financial markets are keeping a close eye on three main categories which would influence corporate earnings or economic growth: taxes, trade and infrastructure.

- **Taxes:** For individuals, Congress and the President are in agreement regarding tax reductions while eliminating loopholes. Both aim to reduce the number of income brackets from seven to just three. Both plans also call for a tax rate reduction in capital gains, dividend, and interest income. As most of the cuts would be felt in the higher brackets, the impact on economic growth is expected to be negligible.

  The domestic corporate rate should also go down. However, a significant part of the cut will be offset by a change towards the treatment of business expensing and interest deductions. The House also wishes to implement a border adjustment scheme which would tax imports by 20% while offering an equivalent rebate on exports. Such a change would favor domestic exporters while penalizing importers, and push the U.S. dollar materially higher. For now, the President has dismissed the idea as "too complicated," but we never know if some form of deal between Congress and Mr. Trump would get this through. For now we would rank this occurrence as a 'medium/low-probability-high-impact' type of risk.

  Most of these tax reform plans will probably change as negotiations start. Even if watered-down reform is passed, it is still expected to be a net positive of around 0.5% of GDP at a minimum. However, these changes would only take effect in 2018.

- **Trade:** For now, there's not much positive for the economy whenever the President talks about trade agreements. The risks stemming from a rise of protectionism are real as tariffs and re-negotiations seems to be more and more likely. The withdrawal of the Trans-Pacific Partnership was expected and of little consequence as the deal was never implemented. However the NAFTA re-negotiation can have a major effect on both sides of the Canadian-U.S. border as the exchanges between the countries are enormous (30% of U.S. trade is through the deal while the proportion is close to 70% for Canada). For now, it seems Mexico is the main target of the U.S. Administration (chart 1) and there's a possibility of a deal between the U.S. and Canada that would exclude their southern partner, but uncertainty remains.

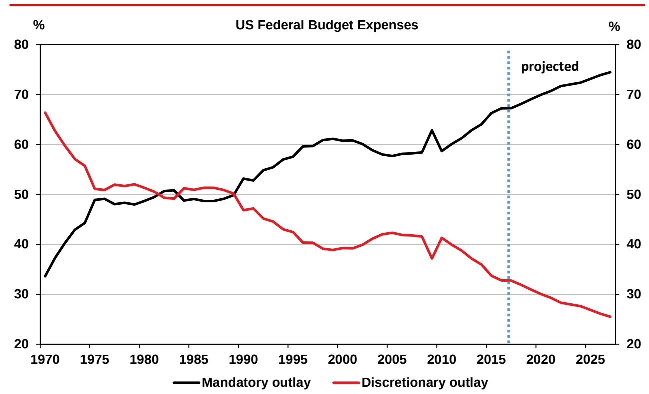
Blame Canada?

Source: Datastream
1

- **Infrastructure:** While Congress and the President are in agreement regarding tax policy, we doubt the same can be said about infrastructure projects. The GOP is usually reluctant to increase deficits on such outlays and, in light of reduced windfalls from tax reform, it will be difficult to change their minds. Mandatory spending is taking an increasing proportion of the budget pie (chart 2) and, even if the Government was able to repatriate $150-250 billion of foreign corporate earnings, it would be a drop in the bucket for GDP growth on the long-term horizon. The timing of such projects is also suspicious, as we are nearing full employment and labor costs are showing signs of acceleration.

Mr. Trump also mentioned he would drastically reduce regulations, but for now the impact of such a plan is hard to assess except that we would expect a friendlier environment for investment if the President follows through.

Higher discretionary spending in a GOP house? Good luck!



Source: Datastream
2

Most of the tax and regulation policies put forth by the Trump Administration would become a long-term tailwind for growth, while protectionism should be considered a short to medium term risk. The separation of powers is still strong in the U.S. The White House has more power in setting foreign policy while Congress is more focused on domestic issues. The legislative process is messy and it's difficult to predict where some initiatives will succeed or fail, and which branch will have the last word. Another factor to consider is how much the President is posturing and offering an extreme position as a starting bid in potential negotiations with Congress or other countries. We are still unsure how much he is willing to compromise and, if he proves adept at doing so, the Trump trade of reflation and higher earnings growth for corporations will have been proven right. If not, then downside risks could materially increase as investors reassess the costs associated with his trade policies, especially regarding China, about which we have little information on the President's plans.

Currencies: Trump vs. his own policies and the Fed

The President argued that the dollar is "too strong" and acting as a headwind to exports which, added to probable profit taking, prompted a selloff of the currency. However, we doubt Mr. Trump will be able to curb the currency's strength in the medium term. This is especially true when most of his actions run contrary to his wishes or the current environment is non-cooperative:

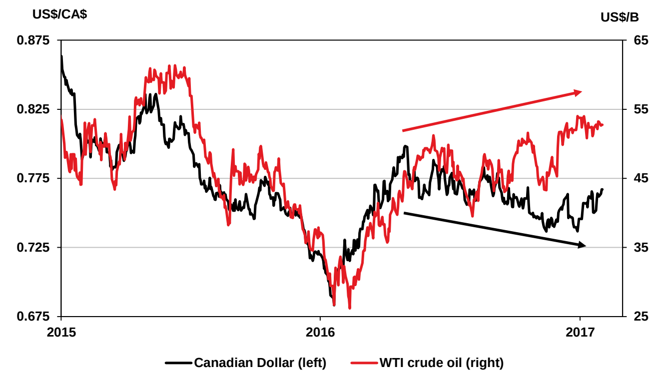
1. His reflation plan should trigger a tighter monetary policy which should act as a support for the greenback. Especially with regard to labor-intensive projects, which would just increase wage inflation in a tight employment market.
2. Income repatriation should have a positive effect on the currency.
3. The greenback would appreciate if he was to implement protectionist barriers, such as tariffs or a border-adjustment tax.
4. As for the Fed, it remains the only central bank that's considering raising its target rate and, therefore, we still believe that policy divergence will push the greenback higher.

As such, the President can't have his cake and eat it too. The Canadian dollar is likely to submit to those pressures, as it seems that recent months saw yield differentials have more impact on the currency pair than crude prices (chart 3). Given this, we suggest keeping a large portion of investments in USD un-hedged for the time being.

Commodities: Keystone XL, positive on the long-term

The approval of the Keystone XL and Dakota Access pipelines by the Trump Administration allows TransCanada to reapply for permission to initiate construction. The process may take a while, as the President has reiterated his wish to renegotiate

Crude oil doesn't explain much of the CAD moves recently



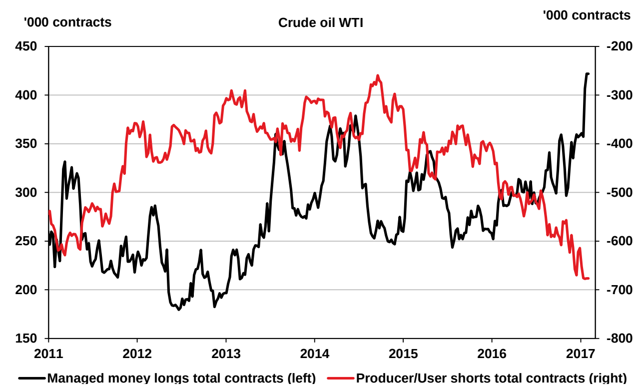
Source: Datastream
3

some terms, particularly regarding building materials which should be of U.S. origin. The project may also have to pass through some court challenges by First Nations and resistance from the local population, but we expect the deal to be approved.

Short term, this announcement is a non-event as we are still two to three years away from any tangible effect. However, once the pipelines are built, the impact on energy prices will be positive for the Canadian economy, as they will offer more flexibility for producers to sell south of the border. The differential between Western Canada Select prices and WTI should contract, and this will improve Canadian producer margins.

For now, we are still waiting for major indications that the OPEC cut is working, as prices seem to have difficulty breaking the 55$ barrier. Market positioning, however, seems to be getting more extreme as speculators are getting longer, while producers are taking advantage and hedging their production (chart 4, next page). While we don't expect a major drop in prices, this type of positioning usually heightens the risks of a temporary pullback as speculative money usually reverses faster than commercial positioning.

Speculators are getting longer; producers are responding



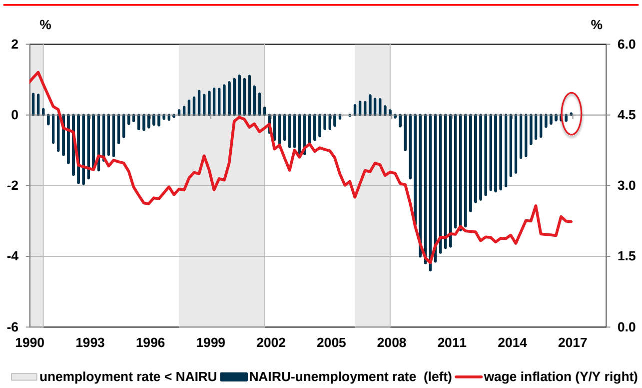
Source: Datastream

4

Fixed income: High surprise potential and uncertainty

For the first time since the great financial crisis, the unemployment rate has now reached levels where labor costs will contribute to inflation (chart 5). This is only one factor amongst many that point toward higher inflation this year. While U.S. dollar strength may drag down import prices, crude oil's base effect (up 57% on a 12-month basis) will act as a counterweight.

A first since the great financial crisis

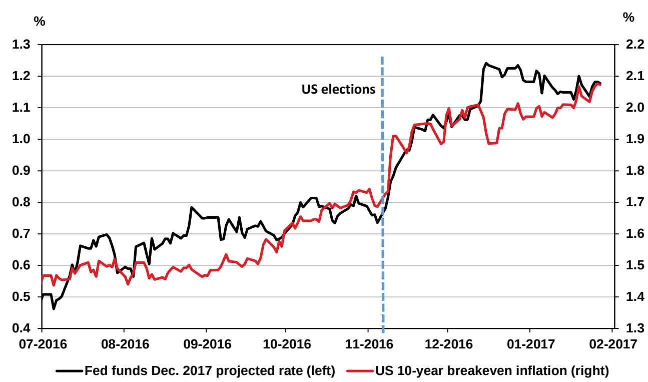


Source: Datastream

5

As the inflationary picture picks up, so do expectations of monetary tightening by the Fed (chart 6). Two hikes in 2017 is the main scenario for the Central Bank right now, with an additional one should the economy perform better than expected, and we believe the committee will keep a close eye on the policies put forth by the Administration, their effects on the economy, and the financial market reaction to them. Tightening too much in the current environment would be ill-advised as it would have the potential to adversely affect global growth, which would increase global risks that could circle back to cause problems domestically.

Data dependency rhymes more and more with inflation



Source: Datastream

6

Even though 10-year bond yields seem to have found some comfort in hanging around 2.5% in the last few weeks, we still believe the path of least resistance is for them to go higher. Therefore, we suggest treading cautiously on the duration-side and invest in shorter-term securities or products offering better protection in a rising yield environment such as non-traditional fixed income. If you have to invest in longer durations, we suggest investments with an inflation tilt.

For credit, as we do not expect a recession in the coming year, we think spread products will outperform less risky assets. Corporate earnings should also improve which should reduce, or at least maintain, investment-grade fixed-income spreads in the upcoming quarters. As we are suggesting a short-duration exposure, taking credit risks helps us mitigate earning potential shortfall from the term premium.

Equities: What comes after a sugar high?

It does seem that, as of now, the rally since the election has been based on the fact that fiscal policies would be implemented fairly fast, "animal spirits" would generate more growth, and bad trade policies would either have minimal effects or would not undergo retaliation from partners. Investing in equities has now become a challenge of weighing the impact of all of those factors while trying to assess if the uncertainty generated will eventually drag prices down with it or just carry on.

Most of what we have discussed has been qualitative in nature. But, fundamentally, equity markets do have to live up to some expectations.

1. The S&P 500 is supposed to grow earnings by 11% in 2017 (table 3, next page). A good portion of that increase comes from energy companies, and most analysts justify

Table 3: Estimated Earnings Breakdown

	2016 EPS	2017 EPS	Growth
S&P 500	**117**	**130**	**11.2%**
IT	44	49	11.4%
Cons. Disc	33	36	9.1%
Financials	25	28	10.9%
Real-Estate	7	5	-24.9%
Industrials	29	30	3.0%
Energy	3	17	415.8%
Materials	16	18	14.0%
Utilities	14	14	-0.1%
Cons. Stap.	26	27	6.3%
Healthcare	51	55	7.6%
Telecom.	12	12	1.6%

	2016 EPS	2017 EPS	Growth
S&PTSX	**745**	**931**	**24.9%**
IT	11	12	12.3%
Cons. Disc	127	143	12.4%
Financials	191	207	8.2%
Real-Estate	176	218	23.9%
Industrials	130	144	11.1%
Energy	12	87	645.5%
Materials	69	103	49.6%
Utilities	104	108	3.5%
Cons. Stap.	225	258	14.6%
Healthcare	63	62	-1.3%
Telecom.	81	86	6.2%

valuations in the sector with crude oil prices staying for a major part of the year in the high $50s (now at 53$).

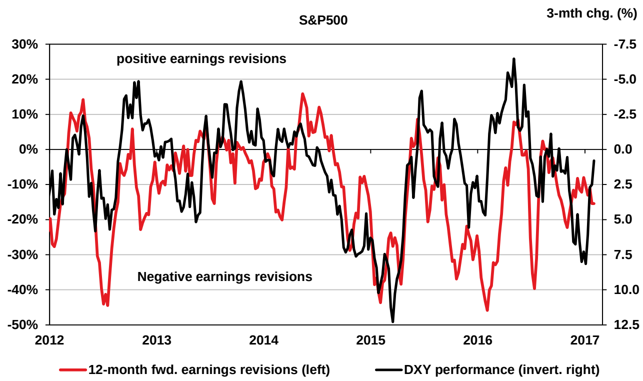
2. Foreign sales account for between 40% and 50% of the total in the index. Any material increase in the greenback would impact growth (chart 7). As we discussed before, we think the policies put forth by the Administration have a chance of pushing the currency higher.
3. Domestically, the Fed Beige book, which outlines the economic conditions across the 12 U.S. districts noted that:

"District reports cited widespread difficulties in finding workers for skilled positions; several also noted problems recruiting for less skilled jobs… Many Districts said contacts expect labor markets to continue to tighten in 2017, with wage pressures likely to rise and the pace of hiring to hold steady or increase."

-The Beige Book, January 2017

The report also noted selling pricing pressures intensified and that "*input costs were more widespread than increases in final goods prices.*" We are left wondering if companies will finally be able to pass those costs down to the consumer or if profit margins will continue to contract. Wage inflation is usually a major headwind on corporate bottom lines (chart 8) and is yet another hurdle to overcome for earnings growth.

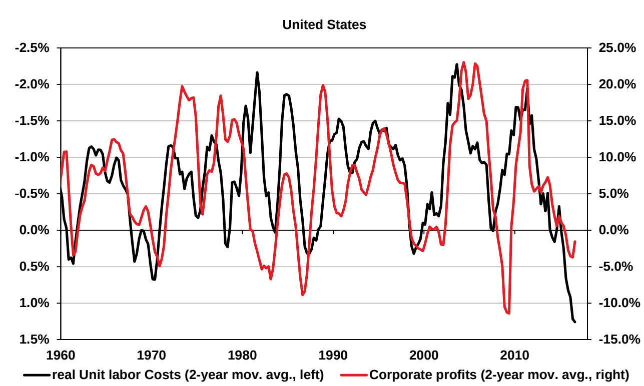
USD has to stay put, for earnings to live up to expectations



Source: Datastream
7

When we add up the points discussed above, it becomes clearer to us that equities seem priced for perfection. The potential for disappointment is high given the current mindset permeating the markets. Even if the VIX showed some signs of life at the end of the month, we can't shake off the feeling that complacency is prevalent. The White House is now an X-factor and uncertainty, even concerning tax policy, remains and increases the potential for extreme movements. Consequently, we suggest an underweight in US equities in favor of cash. If financial ratios improve or we feel the worst of the uncertainty brought forth by the new Administration is behind us, we will be happy to revert back to neutral.

Earnings: Companies will need to pass wage costs to customers



Source: Datastream
8

The story is the same for Canada as investors expect 25% growth for the S&P/TSX, which is due to the increased weighting in the energy sector. While the Canadian economy would certainly benefit from the Keystone XL pipeline approval, the windfall is much too far away in time to have an effect. The country cannot afford to be the victim of protectionism from the U.S. and should the latter implement trade barriers such as a border adjustment tax, we would expect corporate earnings and Canadian growth to take a major hit.

For now, this is not the base case scenario, but the consequences of failure to get a post-NAFTA agreement in place between the two countries are high. Therefore, we think playing defensively with an underweight in Canadian equities is the best position for now.

Emerging markets have benefitted from the recent pullback in the US dollar and favorable global PMIs, however we think the class is at risk of additional credit pressures coming from a greenback rebound and Chinese Yuan weakness.